BOND OVERVIEW

SUBJECT TO COURT
ORDERED CHANGES

An Overview of State Bond Debt
Prepared by the Legislative Analyst's Office

This section provides an overview of the state's current bond debt. It also discusses the impact the bond measure on this ballot would, if approved, have on this debt level and the costs of paying it off.

Background

What Is Bond Financing? Bond financing is a type of long-term borrowing that the state uses to raise money for various purposes. The state obtains this money by selling bonds to investors. In exchange, it agrees to repay this money, with interest, according to a specified schedule.

Why Are Bonds Used? The state has traditionally used bonds to finance major capital outlay projects such as roads, educational facilities, prisons, parks, water projects, and office buildings. This is done mainly because these facilities provide services for many years and their large dollar costs can be difficult to pay all at once. Recently, however, the state has also used bond financing to help close major shortfalls in its General Fund budget.

What Types of Bonds Does the State Sell? The state sells three major types of bonds. These include:

- ***General Fund Bonds.*** These are paid off from the state's General Fund, which is largely supported by tax revenues. Such bonds take two forms. The majority are *general obligation* bonds. These must be approved by the voters and their repayment is guaranteed in the State Constitution. The second type is *lease-revenue* bonds. These do not require voter approval, are not guaranteed, and are paid off from lease payments (primarily from the General Fund) by state agencies using the facilities they finance. As a result, they have somewhat higher interest costs than general obligation bonds.
- ***Traditional Revenue Bonds.*** These also typically finance capital projects but are not supported by the General Fund. Rather, they are paid off from a designated revenue stream—usually generated by the projects they finance, such as bridge tolls. These bonds also do not require voter approval.
- ***Budget-Related Bonds.*** During the past two years, the Governor and Legislature authorized three types of bonds to help address the state's budget problem. These were tobacco revenue bonds, a deficit financing bond, and a pension obligation bond. Repayment of the tobacco bonds is from future payments to California from a settlement with tobacco companies. Repayment of the other bonds would directly or indirectly cost the General Fund. (As of November 2003, there were legal challenges pending on both of these bonds.)

What Are the Direct Costs of Bond Financing? The state's cost for using bonds depends primarily on their interest rates and the time period over which they are repaid. For example, most general obligation bonds are paid off over a 30-year period. Assuming current tax-exempt interest rates for such bonds (about 5.25 percent), the cost of paying them off over 30 years is about $2 for each dollar borrowed—$1 for the dollar borrowed and $1 dollar for interest. This cost, however, is spread over the entire 30-year period, so the cost after adjusting for inflation is less—about $1.25 for each $1 borrowed.

The State's Current Debt Situation

Amount of General Fund Debt. As of November 2003, the state had about $36 billion of General Fund bond debt outstanding—about $29 billion of general obligation bonds and $7 billion of lease-revenue bonds. Also, the state has not yet sold about $21 billion of authorized bonds, either because the projects involved have not yet been started or those in progress have not yet reached their major construction phase. This does not include the authorized $10.7 billion in deficit financing bonds and $1.9 billion in pension obligation bonds.

Debt Payments. We estimate that debt payments for traditional General Fund bonds will be about $2.5 billion in 2003-04. This amount has been temporarily reduced, however, because of the deferral of certain bond payments to help deal with the General Fund's budget shortfall. Debt payments will increase to about $3.5 billion in 2004-05, as previously authorized but currently unsold bonds are marketed. Outstanding bond debt costs would rise to approximately $4.1 billion in 2007-08, and slowly decline thereafter if no new bonds are authorized. If the $12.3 billion in bonds on the March ballot are approved and eventually sold, annual debt service payments would rise to about $5 billion by 2007-08 before declining in subsequent years. The annual General Fund impacts associated with the budgetary borrowing noted above would be an additional $2.5 billion for the deficit financing bonds and about $410 million for the pension obligation bonds over the next five years.

Debt Service Ratio. The level of General Fund debt payments stated as a percentage of state revenues is referred to as the state's debt service ratio. This ratio increased in the early 1990s and peaked at slightly over 5 percent in the middle of the decade. The ratio currently stands at about 3.3 percent, and is expected to increase to 4.6 percent in 2004-05, and further to a peak of 4.9 percent in 2005-06 as currently authorized bonds are sold. If the $12.3 billion in bonds on this ballot are approved and eventually sold, the ratio would increase to about 5.3 percent in 2006-07 and decline thereafter. If the debt service on the budgetary borrowing is included in this calculation, the total debt service ratio would jump to about 9 percent and remain in that range until the deficit bonds and pension bonds are paid off (probably in 2009-10).

Bond Propositions on This Ballot

There is one bond measure on this ballot. Proposition 55 would authorize the state to issue $12.3 billion of general obligation bonds for construction and renovation of public K-12 schools and higher education facilities.